CIPFA consultation:

The Prudential Code for Capital Finance in Local Authorities

Treasury Management in the Public Services: Code of Practice and Cross Sectoral Guidance Notes

Response from the Accounts Commission, April 2017

1. The Accounts Commission welcomes the opportunity to respond to the consultation on both the Treasury Management and Prudential codes.

2. The financial environment now is very different to when the codes were first introduced. The emphasis then was on control over these significant powers and operations; now it has to be on ensuring that these resources are used to maximum effect (as well as being sustainable).

3. The Accounts Commission's interest is in the sustainability of local public services and of councils in particular. We feel that a longer term perspective is needed and one that better demonstrates the sustainability of debt with a clear link between debt and treasury management on the one hand and corporate or strategic plans on the other.

4. Real terms reductions in council funding in recent years have meant that debt servicing costs have risen as a proportion of council budgets, a trend that is likely to continue. Councils also have significant levels of debt for which interest rates are not fixed and this could lead to increased costs in the future. A Scottish council recently issued an index linked bond which necessitates much longer term projections matching costs and funding. The importance of robust and clear treasury management arrangements together with indicators that properly reflect the risks associated with different categories of debt is increasingly important.

5. We published *Borrowing and Treasury Management in councils* in March 2015, available here, and *Borrowing and Treasury Management – Impact report* in November 2016, available here. The focus of the audit was on how councils show best value in borrowing and treasury management decisions. The report includes a number of findings and recommendations that are relevant to CIPFA's current consultation, including the need to take a longer term approach to plans.

6. It may also be useful to note that the Commission's continuing interest in this area is reflected in our work programme, which we published in April 2017. In the programme we have committed to undertake a series of work over 2017/18 and 2018/19 looking at borrowing and debt in more detail, including Non-Profit Distributing projects.

7. We include a response to the two consultation papers below.

Consultation on: The Prudential Code for Capital Finance in Local Authorities

Extract from consultation:

Objectives of the Prudential Code

4. The following objectives of the Prudential Code have not changed since its introduction and are to provide a framework for local authority capital finance that will ensure for individual local authorities that:

   i) capital expenditure plans are affordable

   ii) all external borrowing and other long-term liabilities are within prudent and sustainable levels

   iii) treasury management decisions are taken in accordance with good professional practice

   and that in taking decisions in relation to (i) to (iii) above the local authority is:

   iv) accountable, by providing a clear and transparent framework.

Question 1 Do you consider the four objectives of the Prudential Code are still relevant?

8. Yes.

Question 2 Do you consider that the Prudential Code achieves these four objectives?

9. Partially. In our 2015 report *Borrowing and Treasury Management in councils* we found that councils are not taking a longer term view of affordability and sustainability (see answer to question 9 below).

10. We also found that plans and reports in this area were of variable quality. There was variation in how councils linked the prudential indicators with treasury management strategies and how strategies fitted with the revenue budget setting process. We found that councils were setting and reporting on prudential indicators to the full council and appropriate committees but the level of commentary provided within reports was variable. References in reports to the indicators were often based on the technical definitions, with few giving the overall context or explanations of how indicators are actively used to measure and monitor the affordability of borrowing. There was little explanation of what the indicators actually meant for the council and its communities, in terms of increasing or decreasing pressure on budgets, or any risks highlighted by the forecast indicators.

11. Achievement of the code objectives may be better facilitated if the code was clearer in terms of minimum requirements and good practice requirements. We found aspects of the language of the code quite difficult to interpret in this regard.

Question 3 Do you consider that there are any areas which are not fully covered by these objectives?

12. The Local Authority (Capital Finance and Accounting) Regulations (Scotland) 2016 (the 2016 regulations) and associated statutory guidance requires local authorities to set out their policy on the prudent repayment of debt and the amounts set aside from revenue for that purpose. We note that the four objectives in the prudential code do not cover the prudence of debt repayment policies explicitly. In our Financial Overview of Local Government in Scotland 2015-16 (linked here) we highlight the extent to which debt servicing costs vary between councils. This is in part due to interest payments but also reflects policies and approaches to the repayment of loans fund advances. We think that council policy on set aside for the repayment of debt should be covered by the prudential code.

13. The 2016 regulations also give local authorities power to borrow for grants to third parties for capital purposes and for local authority expenditure on third party assets. Whilst borrowing for these purposes would increase local authority debt and impact the second objective the expenditure is not capital and there is a risk that it is not captured by the first objective around affordability of plans.

14. In statutory guidance that supports the 2016 capital finance and accounting regulations the Scottish Government recommends that authorities produce a single strategy covering investment, capital, treasury management and prudential information. We note that the prudential code seeks to deal with capital finance whilst treasury management is the subject of a separate code. We wonder if consideration ought to be given to the potential benefits from combining the capital finance and treasury management codes for local authorities.

15. There is a need to recognise the inherent risk that one council's view of an affordable capital investment strategy might be significantly different from another's; the level of CFR, which sets a cap on the level of borrowing, is determined by the ambition of an individual council's capital investment plan.

Question 4 Do you agree that the scope of the Prudential Code should be extended to cover mayoral combined authorities?

Question 5 Do you foresee any practical implementation issues with extending the scope of the Prudential Code to cover mayoral combined authorities?

16. We have nothing to contribute in respect of these questions.

Question 6 Do you agree that, in principle, the scope of the Prudential Code should be extended to cover group entities to ensure that any associated risks are transparent and managed?

Question 7 Which areas of the Prudential Code could best be applied to group entities and do you foresee any practical implementation issues with extending the scope of the Prudential Code to cover group entities?

17. Our 2011 report on Arm's Length External Organisations (ALEOs) considered the risks and benefits associated with the creation and use of ALEOs including the need for

consideration of potential liabilities arising from borrowing. We would support the extension of the code in this area, either through the application of all areas of the code to relevant ALEOs or the use of specific indicators.

18. In March 2015 the Commission wrote to all council leaders and chief executives to re-emphasise the need for good governance of ALEOs, including monitoring and reviewing their performance, costs and risks. We note potential complexities around the definition of group and would support the extension of the code to all entities holding debt guaranteed by the council or falling to be met from council funding regardless of their status within the group accounts.

Question 8 How do you suggest the Prudential Code can be strengthened to encompass the risks associated with local authorities' increasing commercial activities?

19. Statutory guidance contained in Local Government Finance Circular 7/2016 identifies a number of options for the prudent repayment of debt. One option links loans fund repayments to the funding or income profile associated with the capital investment. The statutory guidance requires local authorities to keep under review any advances where repayment is linked to income streams to ensure that the provision for repayment remains prudent.

20. We would support the strengthening of the code in respect of this category of debt and would suggest that consideration be given to the need for a separate indicator.

Question 9 – How do you suggest the strategic planning elements of Prudential Code can be strengthened to demonstrate that capital investment is sustainable and that risks are appropriately identified?

21. In your consultation document you highlight the recommendations from our report in relation to considering the long-term implications of decision making. Our 2015 audit highlighted that councils are following the general principles of the relevant codes of practice in demonstrating short-term affordability, but none of the 11 councils we reviewed were adequately highlighting the strategic importance of borrowing and treasury management or clearly analysing and reporting on long-term affordability and sustainability of their borrowing and credit arrangements.

22. The Prudential Code requires councils to estimate the impact of capital investment on the budget for the next three years, as a minimum, and suggests that councils use their own additional indicators. No councils in our sample reported estimates for a longer timeframe, and no councils had developed their own indicators to assess affordability. In our view, three years is inadequate to demonstrate the affordability of borrowing and other credit arrangements.

23. Councils need to clearly set out how current and past decisions impact on the future revenue budget over the medium to long term (5-10 years as a minimum) and over the life of the borrowing term in some instances (eg for PFI/PPP arrangements). Further consideration should be given to the need for separate indicators that reflect the nature of the risks involved for different categories of debt instrument and to the use of sensitivity analysis and scenario planning to better link revenue and capital plans.

Scenario planning should encompass not just changes to the costs associated with debt but also changes to future funding levels.

24. The capital finance and accounting regulations 2016 require councils to set out in their management commentaries how capital investment plans are contributing to corporate objectives and priorities. We would also expect management commentaries to cover the affordability and sustainability of debt, and the council's policy on set aside for repayment of loans fund advances. Further consideration should be given to how best councils can link capital finance and treasury management with their strategic financial story and corporate objectives.

Question 10 Please detail any suggestions for how the prudential indicators could be improved in order that the assurance they provide is enhanced, including details of any indicators which you consider no longer fully serve their intended purpose. Please explain your reasoning

25. Our audit report on borrowing and treasury management highlighted that councils are not always making good use of the indicators. As an example, for the indicator 'impact of capital investment decisions on the council tax/housing rents' we found that three of the 11 councils that we reviewed did not report any impact of capital investment on council tax due to the freeze in council tax in Scotland at the time. Clarification of the calculation requirements for this indicator ought to be considered.

26. We have already noted the Scottish Government's recommendation for a single strategy covering investment, capital, treasury management and prudential information. In our view these strategies and reports ought to consider different categories of financial liabilities separately where balances and risks are significant. We think that further consideration should be given to the need for separate indicators for areas such as: service concession arrangements, leases, LOBOs, and financial guarantees for example. In addition the inclusion of a specific value for money measure for debt restructures would be welcomed.

27. The guidance could perhaps be strengthened to highlight to councils how to make best use of every indicator, and how to use narrative to explain the indicators. Communicating in plain language to non-accountants is an essential aspect of good governance and scrutiny. As a general point we would suggest that the disclosure requirements and risk language used for financial reporting be considered when updating the code.

28. It should be noted that local authorities in Scotland are required to determine the maximum amount of capital expenditure that is affordable by section 35 of the Local Government in Scotland Act 2003 and to set an authorised limit for debt under the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016.

Question 11 If you use local indicators, please provide details including the calculation and how you use the indicator(s).

29. Not applicable.

Question 12 How do you suggest that the Prudential Code can be strengthened to incorporate the concept of the liability benchmark?

30. In principle we would support the introduction of a net loans requirement indicator to supplement the capital financing requirement and the extension of the loan maturity structure indicator by the use of bands for the duration of the debt portfolio.

31. However, it is not clear whether these indicators would be considered capital finance or treasury management indicators.

Question 13 Do you consider that the balance of indicators between the Prudential Code and the Treasury Management in the Public Services: Guidance Notes for Local Authorities is correct?

32. Capital finance and treasury management activities are inextricably linked and single strategies and reports are recommended good practice in Scotland. Separating capital finance and treasury management indicators into two codes is always going to be difficult. As noted above further consideration should be given to the benefits of a combined code for local authorities.

Supplementary response

33. In view of our introductory words on page 1 we would question whether it remains appropriate to call this code the Prudential Code. There is a presumption, from that title, that all borrowing/types of funding decisions are de facto prudent, when it may be the case that certain decisions are found to be imprudent. It is the objective of the code for prudence to be applied when making borrowing decisions that they do not destabilise the long term financial viability of a council. Consequently this consultation might provide the opportunity for further consideration of the title of the code, something which is more closely related to the long term sustainability of councils eg Decision making in relation to the sustainability of debt and treasury management.

Consultation on Treasury Management in the Public Services: Code of Practice and Cross Sectoral Guidance Notes

Question 1 Has your public service organisation adopted the Treasury Management Code?

Question 2 Do you consider that the three principles of the Treasury Management Code are relevant to your organisation?

Question 3 Do you consider that there are any areas which are not fully covered by these principles?

Extract from consultation:

Key principle 1

Public service organisations should put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury management activities.

Key principle 2

Their policies and practices should make clear that the effective management and control of risk are prime objectives of their treasury management activities and that responsibility for these lies clearly within their organisations. Their appetite for risk should form part of their annual strategy, including any use of financial instruments for the prudent management of those risks, and should ensure that priority is given to security and liquidity when investing funds.

Key principle 3

They should acknowledge that the pursuit of value for money in treasury management, and the use of suitable performance measures, are valid and important tools for responsible organisations to employ in support of their business and service objectives; and that within the context of effective risk management, their treasury management policies and practices should reflect this.

1. As noted above there is a clear overlap between treasury management and capital finance and it is not always easy to separate the principles and objectives that underpin the two areas. Some of the points made in response to the consultation on the Prudential Code might equally well sit here and the bigger question is perhaps whether a single code would be preferable for councils. We suggest that a well written code should help secure best practice and not simply set the minimum requirements as satisfactory compliance.

2. We reiterate that the point made above that councils could improve the content and clarity of reports and note that much of language around risk is included in the treasury management code, although the prudential code does refer to risk analysis and management we feel that combining the two codes may better facilitate clear linkage of capital finance and risk analysis associated with different financing options over the longer term.